Statement before the House Government Reform Subcommittee on Energy and Resources
and the Subcommittee on National Security, Emerging Threats, and International Relations

"Russian Energy Policy and its Challenge to Western Policy Makers"

A Statement by

Ambassador Keith C. Smith

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May 16th, 2006

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Mr. Chairman and Members of the Committee, it is a pleasure to appear today to discuss the implications for U.S. and Europe of Russian Energy Policy.

Summary of My Testimony

- **The U.S. and the EU have too long ignored Kremlin's non-transparent and monopolistic energy policies and its use of energy to exert control over the new democracies of Central and Eastern Europe.**
- **The Ukraine-Russian "gas war" in January was only a continuation of Russia's petro-politics, that started with the fall of the Soviet Union in 1990.**
- **The U.S. and Europe's tolerance of these coercive policies and non-transparent business practices have helped signal to the Kremlin that the West needs Russian energy exports more than Russia needs the West's export revenue, energy financing and technology.**
- **A coordinated U.S. and EU energy policy is needed toward Russia to prevent the Kremlin from expanding its political leverage over the new democracies of Central Europe, and also with key Western European nations.**
- **The West must cooperate to make Russian energy policies and actions more transparent, competitive and reciprocal, by following internationally accepted business practices. Western tolerance of Moscow's imperialistic use of energy resources and pipeline monopolies only prevent Russia's own development into a genuine strategic partner.**
- **Recent developments in German-Russian energy relations may seriously hamper European energy cooperation and the region's security interests.**
- **The U.S. and EU should assist Ukraine, Georgia and Moldova by helping them develop alternative pipelines and sources of energy supply.**
- **Central European countries can improve their own security by increasing domestic energy storage, by boosting indigenous supplies of gas and oil and by creating a welcoming and transparent environment for foreign investors.**

A Delayed Wake-up Call

Gazprom's January 1st cutoff of natural gas to Ukraine was a much delayed wake-up call for Western Europe and the United States regarding Moscow's willingness not only to use its energy resources as political leverage in Europe, but also to undermine the new democracies that most recently emerged from decades of Kremlin control.[1] Russia's recent sharp increases in natural gas prices to Ukraine, Georgia, Armenia and Moldova, and its increasing control over Europe's gas pipeline systems, raise fresh issues concerning Russia's foreign economic policies and the security implications for Europe. Russia's energy strategy also raises the stakes regarding America's own growing dependency on energy imports, and should lead us to question expectations that Russian supplies of gas will help America's energy security. Unfortunately, the U.S. and Western Europe have largely ignored this problem until recently because the coercive nature of Russia's petro-politics has largely been confined to East Central Europe and Central Asia.

For many new EU member states such as Poland, Latvia, Lithuania, and for new democracies, such as Ukraine, Georgia, and Moldova, Russian energy control is an old problem. Central European attempts to raise this issue in Western capitals have until recently been brushed aside. The rapid acceptance in 2005 by the EU Commission of the Russian-German undersea gas pipeline project was a serious mistake and raises questions about Europe's ability to implement a common foreign and security policy. The concerns voiced by the Central Europeans should have been examined in detail both in Brussels and in European capitals. More attention should have been focused on the agreement's implications for Europe's long-term energy security, and on the ability of the new EU members in Central Europe to resist Moscow's political and economic influence.

The European Commission and the United States have only started looking seriously at the risks to Europe and the West of dependency on Russia after the cut off of gas to Ukraine in January of this year. Nevertheless, the slowness of our response is leaving Russian companies plenty of time to stitch together additional bilateral deals with Western governments, all anxious to help their companies gain an investment foothold in Russian energy production. A re-examination of EU policy may be made more difficult by the curious fact that Russia plays an important role in the EU's own Energy Treaty Commission (ETC). This is the case, even though Moscow has refused to ratify and implement the Energy Charter, and particularly the draft Transit Protocol. Ratification and implementation of this agreement would have resulted in greater competition in Russia's energy transportation sector. In spite of pressure from the EU to ratify the Charter, Gazprom's Deputy CEO Medvedev has labeled it as a "stillborn document."

[1] "Russia stops natural gas to Ukraine: Pipeline to EU nations could be in jeopardy," Alex Rodriguez. Chicago Tribune, January 2, 2006.

[2]Gazprom believes that its bargaining position outweighs that of the EU or U.S. as a result of high energy prices and of instability in producer countries. In any case, the long-term political and security significance of the Putin Government's assertive energy policies warrants much closer study by Western governments, including by the United States.

There is an unrealistic expectation in some circles in the U.S. that Russian natural gas supplies from the Russian Far East or from off-shore in the Barents Sea will fill the gap created by declining domestic and Canadian production and by political instability in Latin America, Nigeria and the Middle East. The reality is that Russian oil and gas exports are not growing at the pace they were just 3-4 years ago. In addition, investment in Russian exploration and development has declined from the level that existed before the systematic destruction of Yukos began in 2003 and paralleled the increased centralized control of almost all oil and gas resources under the Kremlin Administration. Another factor to consider is that Russia, as it has in Europe, will demand easy non-reciprocal access to U.S. "downstream" facilities as a price for U.S. company participation in Russian energy production, particularly in the giant Shtokman gas field in the Barents Sea.

Pipeline Politics and Western Vulnerabilities

The Putin Government has made it clear that it intends to use its energy export power to regain Russia's Cold War influence around the world. Former Kremlin economic adviser, Andrei Illarionov, who was pressured into resigning last December, has cited Russia's increasing tendency to use energy as a weapon in its relations with other countries. This warning by a former Kremlin insider should be taken seriously by Western governments.[3] Gazprom's recent takeover of the Armenian and Moldovan gas pipeline systems and its actions in Ukraine demonstrate Russia's willingness to use its considerable energy muscle to secure control of the energy infrastructure in neighboring states for political purposes.[4]

EU ambassadors in Moscow were recently warned by Gazprom's CEO, Alexei Miller, that Russia could divert natural gas now going to Europe to China and the U.S. if the company were not allowed more freedom to buy of European downstream energy facilities. Milller was not offering similar access to Russian energy markets. This comment was quickly followed by a similar threat from President Putin. Little attention was given in the Western press to the fact that Russia does not allow Western firms the same degree of access to Russian facilities that Russian state energy companies already have in Europe and the United States. Moscow clearly believes that the tight world

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2 Richard Orange, "Don't stand in our way; in the 20 years I've been doing this, I've never seen Gazprom exert this extent of bullying or political pressure," The Business, April 30,2006

3 "Russia: Putin's ex-ai

de says he quits because he could no longer speak out," BBC Monitoring, December 30, 2005.

4 "Russia's gas contacts with Armenia require complex approach," RIA Novosti, December 7, 2005;

"Moldova-Gas debt grows 98% to $496 million in 2004," ITAR-TASS News Agency, July 29, 2005.

energy market and high prices provide it with enough leverage over the West to pursue non-reciprocal policies and to continue to follow monopolistic, non-transparent business practices.

"Pipeline imperialism" by Moscow dates back to 1990, when it interrupted energy supplies to the Baltic States in a futile attempt to stifle their independence movement. The "energy weapon" was again used against the Baltic States in 1992, in retaliation for Baltic demands that Russia remove its remaining military forces from the region. In 1993 and 1994, Russia reduced gas supplies to Ukraine, in part, to force Kiev to pay for previous gas shipments, but also to pressure Ukraine into ceding more control to Russia over the Black Sea Fleet and over Ukraine's energy infrastructure.[5] Even Belarus, and indirectly Poland and Lithuania, suffered supply disruptions in 2004 from the Kremlin's effort to take over Belarus' gas pipeline system. From 1998 to 2000, in an attempt to stop the sale of Lithuania's refinery, port facility, and pipeline to the Williams Company of Tulsa, Oklahoma, Transneft, Russia's monopoly transporter of piped oil, stopped the flow of crude oil to Lithuania *nine* times.

Russia's Gazprom, with the help of Germany's Ruhrgas, exercises control over the gas facilities and pipelines in the three Baltic States, where they also have monopoly control of the domestic gas markets in all three Baltic States.[6] Media outlets in the West have generally ignored Transneft's refusal to allow Kazakhstan to supply oil to Lithuania's Mazeikai Refinery through the Russian pipeline system. Kazakhstan's oil company has the legal right to ship crude oil to the Baltic coast, based on their transit agreement with Transneft agreed to last fall.[7] Moscow is determined to prevent any but a Kremlin approved company from taking over the Yukos ownership of Lithuania's facilities. Three years ago, Russia stopped all piped shipments of oil to Latvia in an effort to gain control over the oil port at Ventspils. Now, Moscow is again attempting to keep non-Russian companies from buying Lithuania's Mazeikai Nafta Refinery and the port at Butinge, on the Baltic Sea. This use of pipeline imperialism is ignored in the West even though Latvia and Lithuania are EU and NATO members.

The Russian pipeline monopolies of Gazprom (natural gas) and Transneft (oil) have been given free rides in terms of the open-market requirements of WTO and the EU's own Energy Charter. The EU's agreement with Russia on WTO in effect gave Moscow's increasingly monopolistic pipeline and production companies carte blanche to avoid following accepted Western business practices.[8] The WTO agreement with the EU (not challenged by the U.S.) also allowed Russia to maintain a trade advantage in industrial goods by keeping its domestic energy prices at a fraction of world market prices.

5 Paul J. D'Anieri, Economic Interdependence In Ukrainian-Russian Relations (Albany: State University of New York Press, 1999),

6 Energy Intelligence Agency; country analysis briefs, Baltic Sea Region, March 2005.
http://www.eia.doe.gov/emeu/cabs/baltics.html

7 Valeria Korchagina, "Kazakhs Fume Over Lithuanian Oil Deal," Moscow Times, November 21, 2005.
"Transneft stops oil transit from Kazakhstan to Lithuania, Elta-Itar-Tass, Nov 17, 2005.

8 European Commission report on the EU – Russia Energy Dialogue. http://europa.eu.int/comm/energy/russia/overview/index_en.htm

German-Russian Energy Relations

Russia stands to greatly increase its market share and its leverage in Germany and the rest of Europe through the construction of the expensive undersea **Northern Europe Gas Pipeline (NEGP)**. The construction of a parallel pipeline to the Yamal I line that runs through Poland would have been a much cheaper alternative (now estimated at $10.5 billion for NEGP vs $2.8 billion for Yamal II)[9]. In addition, the enlargement of the Yamal line would have given both Central and Western European energy consumers greater political and economic security.[10] The increased costs of the NEGP will be passed on to Western consumers to the benefit of Russian and German gas suppliers and the German banking community.

Chancellor Merkel struck a cautious tone during her December visit to Warsaw when referring to the NEGP project. She said; "We want this project to be accessible to everyone…and the interests of all involved parties should be taken into account."[11] Later however she announced her full support for the original deal, as signed by former Chancellor Schroeder one week before leaving office. This deal involving Russia and Germany, included the granting of a 1 bilion loan guarantee by the German government for the pipeline's construction. With the recent signing of agreements between Russian companies and BASF, EON and Ruhrgas, it appears as if the new government in Berlin will be supporting Gazprom's aggressive ownership inroads into German gas and electricity companies. German energy policies have created significant anxiety among Central Europeans concerning the West's willingness to help protect their newly won sovereignty.

The Russian-German agreement, unless modified, will give Russia's state-run Gazprom a significant voice in German domestic energy policies, and indirectly over the gas markets in all of Central Europe. Germany as an energy market and a source of bank financing, however, is crucial to Russian development. Germany should follow through on Chancellor Merkel's promise to implement a German energy policy that takes into account the security interests of the Baltic States and Poland. If changes are not made in the Schroeder-Putin agreement on the Baltic pipeline, Germany may face an increasingly insecure neighborhood to its east. Germany may also down the road confront the same Russian control of its domestic energy markets that face the newly independent states who so recently emerged from Soviet domination.

No single country wields more influence in Moscow than does Germany. The trade and financial ties between Berlin and Moscow are important to the sustained development of both nations. Although many outside of Germany were disappointed with Chancellor Schroeder's support for President Putin's domestic policies, everyone recognizes the value to European security of a close, constructive German-Russian

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9 Ariel Cohen, "The North European Gas Pipeline Project" < http://www.harrimaninstitute.org/MEDIA/00491.pdf>

10 "Poland Wants Expanded Yamal-Europe Pipe", Russia & CIS Oil and Gas Weekly, December1, 2005.

11 Yelena Shesternina, "Chancellor of Germany Urges Poles not to Fear," Izvestia, December 6, 2005

relationship. Good friends, however, should not avoid frank discussions of latent imperial tendencies in Russia's foreign policies. Germany continues to become more dependent on Russian gas imports (now over 44% of all the gas that Germany imports). This import dependence could well grow to 80% after the completion of all phases of the Northern Europe Gas Pipeline (NEGP).

Is the West Paying Attention?

Europe's energy relationship with Russia has for the past several years been directed by only a few of the larger member countries. The leaders of these countries have too often praised President Putin's democratic credentials while ignoring Russia's backsliding on democracy and the coercive use of Russian energy power. The U. S. has also been until quite recently more eager to secure energy supplies from Russia than to pressure the Kremlin into reforming its economy. The EU and the U.S. have ignored the noncompetitive and political aspects of Russia's energy export policies. This is due in part to competition by Western companies for exploration and production rights in Russia. Although the EU recently initiated a more comprehensive study of the Community's energy security, the large countries of Europe continue to resist submitting to a common EU energy policy. Meanwhile, Russian companies are rapidly locking up non-transparent business deals with individual European nations.

We should expect that Moscow's exercise of "petro-politics" will be a subject for discussion at the G-8 summit. This vital issue also needs more discussion within the EU Commission, and between the Commission and other importing countries such as the United States and Japan. Russia's Deputy Prime Minister and Gazprom Deputy CEO, Alexander Medvedev, told the British daily, The Guardian, in January, that "politics is always there" when one is doing energy business.[12] This is no surprise, but our relying on energy from an increasingly authoritarian government intent on increasing Russian political influence in neighboring countries, is troubling. If on the other hand Russia's energy wealth were more transparently and competitively managed, it would dramatically increase domestic Russian living standards, bring Russia real international respect and help cement a Europe that would feel more unified and secure.

Europe as Hostage to Russian Energy

The importance of good relations between Russia and the West, and particularly between Germany and Russia, cannot be underestimated. Nevertheless, it is a mistake for us to give Moscow the impression that we believe that the West needs Russian energy supplies more than Russia needs the oil and gas revenue that comes from the Western markets. Nor is it wise to let the Putin Government believe that its authoritarian domestic policies are acceptable in the West as long as there is an expectation of increasing exports of Russia's energy resources. Simply stated, Russia is not able to develop its vast energy

12 "We won't be turning off the taps, Russia's gasman reassures Britain: Gazprom deputy on Putin, Ukraine and ambitions to increase output to the UK," Terry Macalister. Guardian Financial Pages, January 18, 2006.

fields in Siberia, the Pacific Coast and in the Barents Sea before the middle of the next decade without Western capital and technology.

There are growing indications that Russia will be unable to meet European, Chinese, Japanese and American expectations for significant increases in energy imports unless Russia offers foreign investors a significantly greater participation in exploration and development of Russia's new gas and oil fields. Russian gas exports to the West are already dependent on Gazprom's ability to monopolize and control gas exports from Turkmenistan, Kazakhstan and Uzbekistan.[13] This Russian dependency on Central Asia will increase over the next 7-10 years, until there are substantial gas flows from the Shtokman field in the Barents Sea, and from new wells in the Sakhalin and Siberian fields. In the past, Gazprom has neither had a reputation in the industry for innovation nor for productivity increases in exploration and development. With the company now under tighter control by the Kremlin, there are good reasons to question whether Gazprom and the increasingly powerful Rosneft will have the managerial skills, financing and technology necessary to meet Russia's export goals through increased domestic production.

There has been no coordinated push by either the EU or the U.S. to require that Russia open its energy market to foreign investors in the same way that Western companies and markets are open to Russian investors. Lukoil has been allowed to buy 100% of Getty Petroleum in the U.S., along with 1,500 gas stations. U.S. energy companies can, according to Russian law, only own 49% of a Russian company and in practice 20% ownership appears to be the ceiling set by the Kremlin. We should be using our considerable leverage to force Russia to play by the same transparent, competitive rules that guide business in the West. Western governments should not have acquiesced to this uneven playing field, but should have demanded full reciprocity with Russia in their investment policies. This would help promote the kind of investment that would increase, rather than decrease, economic reform and a more balanced growth in Russia itself. President Putin has compared the new Gazprom colossus to Norway's Statoil, but the latter has real domestic competition, its exports are divorced from foreign policy and it is a totally transparent company.[14] Gazprom, with its interlocking ties to the Kremlin Administration and its gas pipeline monopoly, cannot be compared to any Western firm.

The pipeline monopolies of Transneft and Gazprom are contrary to the Energy Charter signed by the EU and Russia. Where is the pressure on Russia to ratify and implement the charter?[15] Following the destruction of Yukos, Russian officials declared that private companies would not be allowed to build pipelines in their country.[16]

13 "Ukraine is increasingly dependent on Gas from Turkmenistan," Ethan Wilensky-Lanford. New York Times, January 10, 2006. "Russia, Ukraine end gas row, Europe queries energy dependence," Agence France Presse, January 4, 2006.

14 Pavel K. Baev, "Putin, Gazprom, and the other Norwegian company," Eurasia Daily Monitor, February 6, 2006.

15 < http://europa.eu.int/scadplus/leg/en/lvb/l27028.htm> Last updated: 13.08.2001.

16 "Putin may allow private companies to build pipelines in Russia," Prime-Tass, April 29, 2004.

Former Siloviki Making Energy Policy

Former intelligence officers (siloviki) in the Putin administration and in Russia's energy companies have a strong role in determining national energy policy. The head of Rosneft is a former KGB associate of President Putin, and he helped engineer the breakup of Yukos and his company's seizure of the most valuable assets of Yukos.[17] Former KGB and GRU officers sit on the boards of almost all the country's major energy companies. In 1999, Moscow went so far as to send a former KGB/FSB officer as ambassador to Lithuania, in an attempt to provide behind-the-scenes support to Lukoil's negotiations with the Lithuanian Government and the Williams Company. Before assuming the job, the ambassador had been the FSB's official liaison officer with Lukoil.

A few former intelligence officers are quite progressive in their views. The majority of them, however, oppose any weakening of the state through the growth of a transparent, independent private sector, and find the idea of a win-win energy deal with a Western company generally to be an alien concept. Granting majority control to a Western energy firm is viewed by most former intelligence officers as a danger to Russia's national security interests. Even the Western managers of TNK/BP are no longer permitted to see their company's own seismic data. President Putin's use of Matthias Warnig, a former East German Stasi officer and now Dresdner Bank executive, to play a central role in financing and managing the undersea Baltic pipeline system only added, perhaps unfairly, to suspicion that the project is more politically than commercially motivated.[18] Mr. Warnig, who was earlier proposed by Gazprom to sit on its board, will work directly under former Chancellor Schroeder in managing the Baltic pipeline system.[19]

Ceding Too Much Control to Gazprom

More thought should be given by Western governments to the potential power of Gazprom to control the gas markets in Central Europe following the completion of the Baltic pipeline system in 2011-12. Under the German-Russian agreement, Gazprom will be able to buy significant shares in Germany's gas companies.[20] Will this allow Gazprom to veto shipments of gas from Germany to Poland if the Poles have a dispute with Gazprom over price or availability and Russia decides to reduce or cut off the flow of gas? Could the increased power of Gazprom be used to stop liquid natural gas (LNG) receiving plants from being constructed in Poland, Latvia, or even in Germany? How much more political influence will Moscow have in Berlin as a result of Germany's growing energy dependency on Russia and of Gazprom's large ownership stake in Ruhrgas?

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17 Alexei Polukhin, "1.1 The Gas Secrets Non-disclosure Agreement," Novaya Gazeta, No.94, December 15, 2005, p.3.

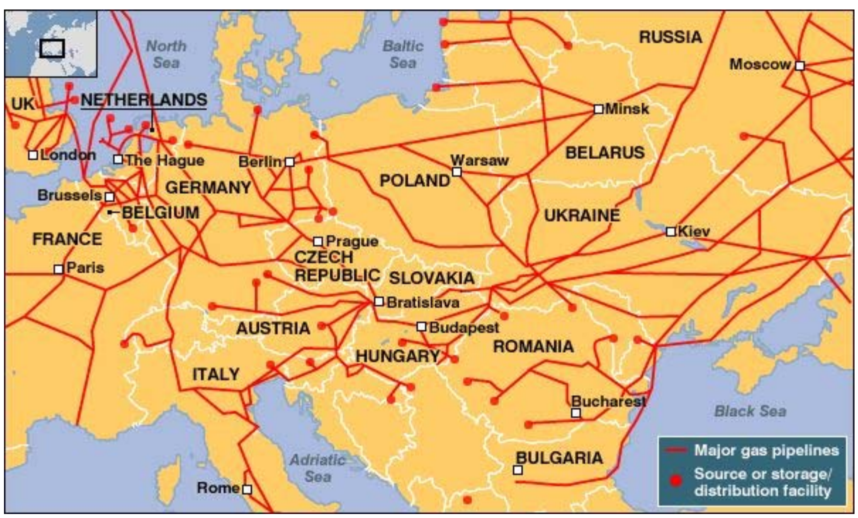
18 Sally Bogle, "Gazprom, E.ON, BASF Begin Construction Work on NEGP, May Offer 9% to New Investor," World markets Analysis, World Markets Research Centre, December 12, 2005.

19 "Government office chief replaces Novikov as Gazprom candidate," Russia & CIS Energy Newswire, February 9, 2006.

20 "BASF, Gazprom strengthen ties, deepen cooperation in energy supply," Agence France Presse, April 11, 2005.

The EU has proposed that member states increase their levels of natural gas storage. This may become more difficult now that Poland and the Baltic states are being bypassed by the NEGP. Russian purchases of gas from Turkmenistan, Uzbekistan, and Kazakhstan are designed to deny the West, including countries such as Ukraine, the ability to buy oil and gas directly from Central Asia or at prices negotiated between producer and consumer, rather than working through Gazprom.[21] The company buys Central Asian gas at $55 a cubic meter and sells Russian gas in Europe for over $240. Monopoly control of the pipelines out of Central Asia is extremely profitable - for Russia. There is a question as to whether this coercive pipeline policy of the Kremlin is compatible with WTO membership. Considering our experience with China's WTO compliance, there are good reasons to doubt that Russia will let up its monopolistic pressure on Central Asian gas shipments after it has been admitted to the WTO. More open and competitive energy policies by Moscow before WTO membership would be wiser than repeating the China experience.

Gazprom is attempting to pressure Bulgaria into breaking a binding agreement on gas price and availability that would be in force until 2010.[22] It is important for the EU to give this soon-to-be member state political support, perhaps using the forum of the Common Security and Defense Policy. So far, there is no sign that Brussels will intervene. Perhaps Bulgaria, as a member of NATO, should put the issue of energy security on NATO's agenda as suggested by Poland. NATO members have historically used the Alliance to examine issues that go beyond narrow questions of military defense.



EUROPE'S GAS PIPELINE NETWORK

Source: *Inogate (EU oil and gas transport co-operation programme) via BBC News*

21 "Gazprom Established Control Over All Gas Resources of Three Asian Republics", The Russian Oil and Gas Report, November 14, 2005.

22 "Bulgaria Refuses to Review Gas Contract with Russia's Gazprom," Agence France Presse, January 6, 2006.

No Big Winners in the Russia-Ukraine "Gas War"

This brings us to the Russia-Ukraine "gas war," that was allegedly resolved to the satisfaction of both sides on January 4. Russia's political agenda in using gas prices to punish the pro-Western Yushchenko government seems quite clear from statements made by Russian supporters of Moscow's hard line toward Kiev and from remarks by Russia's few remaining reformers[23]. Moscow was obviously surprised and displeased by the December 2004 election of Victor Yushchenko and unhappy with his policies of moving Ukraine closer to the EU and NATO. This provoked Moscow into demanding revisions of the 2004 gas agreement that was written at Moscow's insistence in order to help Viktor Yanukovich's presidential aspirations. It is highly unlikely that Moscow would have demanded that Ukraine immediately pay "world market prices" for Russian energy imports if the pro-Moscow Viktor Yanukovich had taken power after the earlier rigged elections. It should not surprise anyone that the cut off of natural gas by Gazprom came in the middle of one the coldest winters in recent Ukraine memory and less than three months before crucial Ukrainian parliamentary elections.

Not many people familiar with political and economic relations between Russia and Ukraine believe that the current natural gas agreement will last very long.[24] And we would also be naïve to think that the present agreement will last beyond the next year without a Russian demand for revision and price increase. Moscow's requirement that all gas to Ukraine be contracted through the nontransparent company RosUkrEnergo, the direct successor to the even less-transparent EuralTransGas, raises questions about the reliability of future gas supplies that originate in Central Asia or in Russia itself[25]. It is not likely that the newly formed UkrGazEnergo will be any more transparent than the companies mentioned above, particularly in light of the continued lack of transparency in Gazprom and Naftogaz Ukrainy, and the fact that RosUkrEnergo remains a player under the "final agreement" signed by both sides on January 4. It is not a good omen that five or six agreements signed on January 4 between Ukraine and Russia were not made public by officials of either side. The reported "revelation" regarding the Ukrainian partners in RosUkrEnergo by a Gazprom owned newspaper should not be taken at face value. Over the past thirteen years, Moscow has clearly signaled that its intentions are to control Ukraine's gas pipeline system, just as it now controls the gas pipelines in the Baltic States, Belarus, Poland, Armenia, and Moldova.

No one should have been surprised by Moscow's tough stance towards Kiev. Russia's willingness to stop energy shipments to Ukraine for political reasons goes back more than ten years. Nevertheless, one can make a good case that Russia has the right to charge importing countries market prices. An equally good case can be made that it is in the long- term interest of Ukraine and other importers to move in the direction of paying

23 "Russia: Putin's ex-aide says he quits because he could no longer speak out," BBC Monitoring, December 30, 2005.

Fred Weir, "Russia-Ukraine Gas Standoff," Christian Science Monitor, January 3, 2006.

25 "Gazprom wants Naftogaz to take 50% stake in RosUkrEnergo" Interfax News Agency,Russia & CIS Business & Financial Daily

world prices. Once market prices are reached, Moscow's political leverage will decrease. A four-fold overnight increase in price from $50 to $230 per 1,000 cubic meters as originally demanded by Russia last December, however, was not justified, particularly in light of the 2004 agreement between the Kuchma Government and Gazprom, which locked prices in until 2010.[26] Both sides should have taken the dispute over the agreement to international arbitration.

Part of the Kremlin's present strategy is to rapidly increase prices to weak neighboring states in the hope that they will build up large debts, be unable to pay for the gas, and ultimately have to cede control over their domestic gas pipelines to Gazprom or Transneft to pay for the arrearages. This is what has happened in Belarus, Armenia and Moldova and is currently being threatened in Ukraine, Bulgaria, Belarus and Slovakia. The West should also be concerned with Gazprom's move to monopolize all gas supplies from Turkmenistan, Kazakhstan and Uzbekistan. This monopoly position increases Moscow's political leverage in East Central Europe and may increase prices in the medium term in all of Europe.

It would help if we knew what the real market price of Russian gas and oil would be if a transparent situation existed within Russia's exporting companies. If Russian consumers were forced to pay prices that were significantly more than one-fifth of what Moscow claims to be the world market price, domestic demand would drop and additional Russian oil and gas would be placed on the international market. Does the $47 per 1,000 cubic meters charged to Belarus have any relationship to the market, or does the Kremlin consider this an "internal price?" These are all questions that need greater discussion and scrutiny in European capitals, in Washington and in the EU Commission.

Ukraine Needs to Act to Strengthen its Own Hand

Ukraine's politicians, however, deserve some of the blame for the country's present situation. Kiev has allowed corrupt oligarchs to continue their control over gas deliveries from Russia and many of the domestic oil and gas fields. Even more damaging in the long run is the Yushchenko Government's lack of movement in developing fair and just conditions for both domestic and foreign energy investors. Here again, a few powerful individuals, most of them with close ties to Russia, have successfully kept out Western competitors. Ukraine could substantially reduce its dependency on Russia through rapid reforms that would permit more open tenders for exploration rights and a welcoming atmosphere for legitimate foreign energy investors. Seismic studies demonstrate that the country possesses considerable gas both on-shore, in the Black Sea and possibly in the Sea of Azov.

The present government in Kiev did inherit a situation in which there was little transparency in the entire energy market. Two thirds of Ukraine's refineries, processing

26 Daniel Kurdelchuk, Olexander Malinovsky and Inna Novak "A European Approach to Ukraine's Gas Dilemma: Road map to solve the dilemma" Mirror-Weekly, International Social Political Weekly, No.49 (577) December 17-23, 2005.

three-fourths of the country's oil, were already owned by Russian companies.[27] Almost 100% of the refined product that is exported, is produced in Russian-owned companies. Ukraine's nuclear plants depend on Russian nuclear fuel rods. Former Russian Prime Minister Victor Chernomyrdin, who was also CEO of Gazprom, has for many years been Moscow's ambassador to Kiev. He has effectively promoted Russian energy interests.

The cozy relationship between Russian and Ukrainian energy interests persists, even after the New Year's Day reduction of gas supplies. Talk by the Yushchenko Government over the past year about diversifying imports and stopping corruption in the energy sector has resulted in some progress, but it has been too slowly implemented [28]. The economics of the proposed Odessa-Brody oil pipeline are still in question, although it may be needed for security reasons. The NABUCCO gas pipeline project, which would go from Azerbaijan through Turkey to Austria, is a realistic alternative to gas shipments that go to Ukraine through Russia. A more immediate need is for the current Yekhanurov government to embark on an urgent program to improve energy efficiency, and to open the country's oil and gas fields to Western investors. Unfortunately, negotiations to form a new government after Ukraine's parliamentary elections in March have still not been successful, thereby perpetuating paralysis is much of the country's decision making apparatus.

Western acceptance of Russia's "neo-colonial" policies in Eastern Europe, the Caucasus and Central Asia are not in the long-term interests of Russia itself. Acquiescing to Moscow's more "robust" regional policies has only contributed to greater tension in Russian-East European relations and has slowed the development of democratic governments in the Caucasus and Central Asia. This in turn encourages and strengthens non-democratic elements in Russia that believe that their country's strength and prestige stems from control of the neighborhood – a large neighborhood at that.

Time for the West to Lead on Energy Policy

The EU should take the lead in building a more secure network of electricity inter-connectors between the countries of Western, Central and Eastern Europe. The EU could help marshal the international banks, such as the EBRD and EIB to take equity positions in the pipeline systems of Ukraine, Bulgaria, Moldova and Poland. This would help these countries modernize their pipelines and it would provide a "neutral" party that could keep the pipelines from being controlled by non-transparent Russian companies and guarantee competition in gas and oil transportation. International financing for the proposed NABUCCO natural gas line from Azerbaijan would offer Central Europe needed energy security, as would the building of the Odessa-Brody oil pipeline system.

The United States should re-examine its long-term energy relationship with Russia. Support for American investment in Russia's energy resources should not prevent us from demanding more transparent energy policies and a level playing field for

27 "Ukrainian Oil Specialist Against Building of More Oil Refineries," ITAR-TASS, May 20, 2005

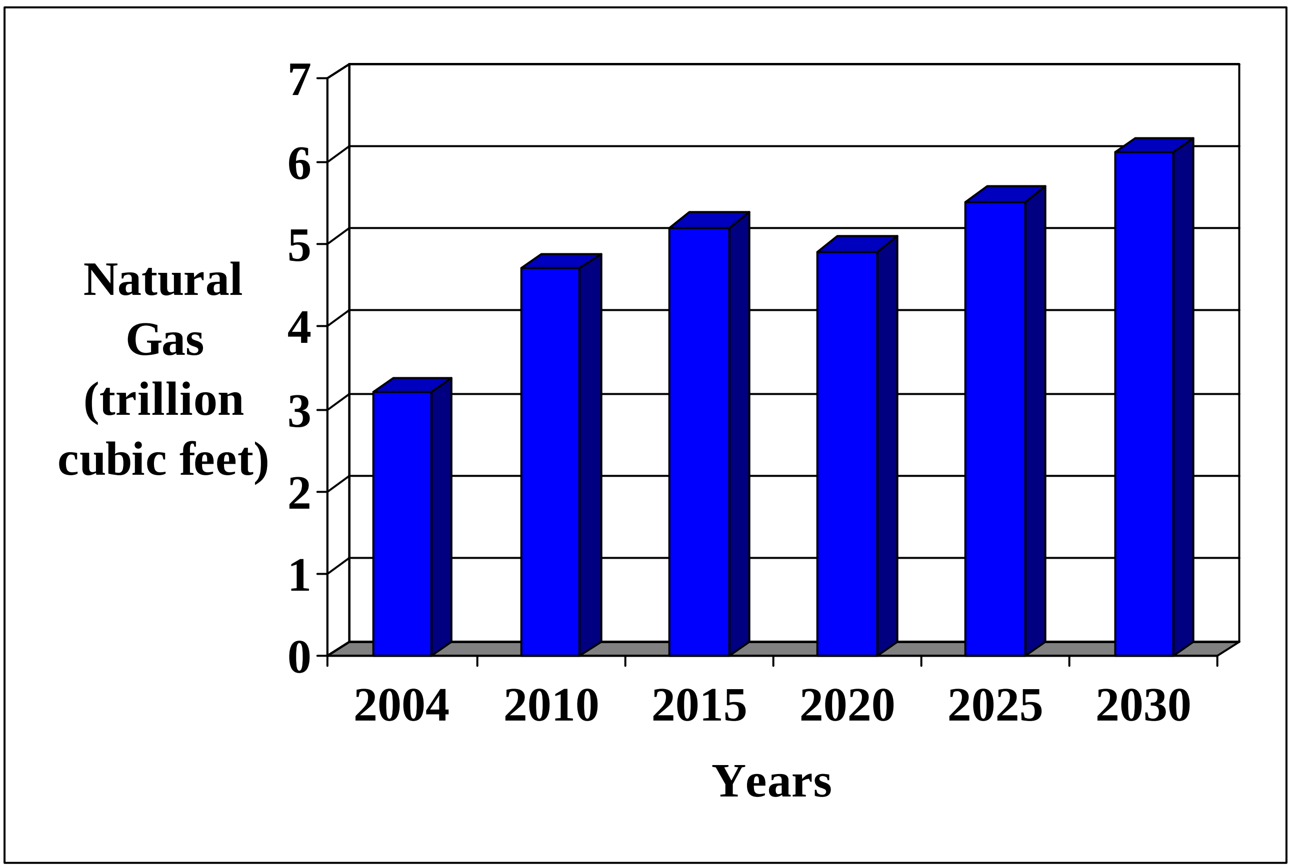
28 "Ukrainian president outlines challenges at public forum," BBC Monitoring Kiev Unit, November 28, 2005

foreign investors. We should expect a loosening of Russia's monopoly pipeline system and demand that Central Asian energy producers have direct access to Western markets. We are not being hostile toward Russia when we insist that there be reciprocity in Russian-European-U.S. energy relations. It would be foolish on our part not to see Russia evolve into an economically successful democracy. Everyone would gain. Russians are going through a difficult period psychologically. They are highly suspicious of America's motives in Central Europe and Central Asia and tend to believe that the U.S. and NATO are intent on "surrounding" Russia with hostile states; part of a grand scheme by the West to keep Russia weak economically and marginalized in international affairs. It is necessary for us to address these issues head on with our Russian colleagues, and at the same time work to counter Russian efforts to acquire psychological security by creating insecurity in Europe.

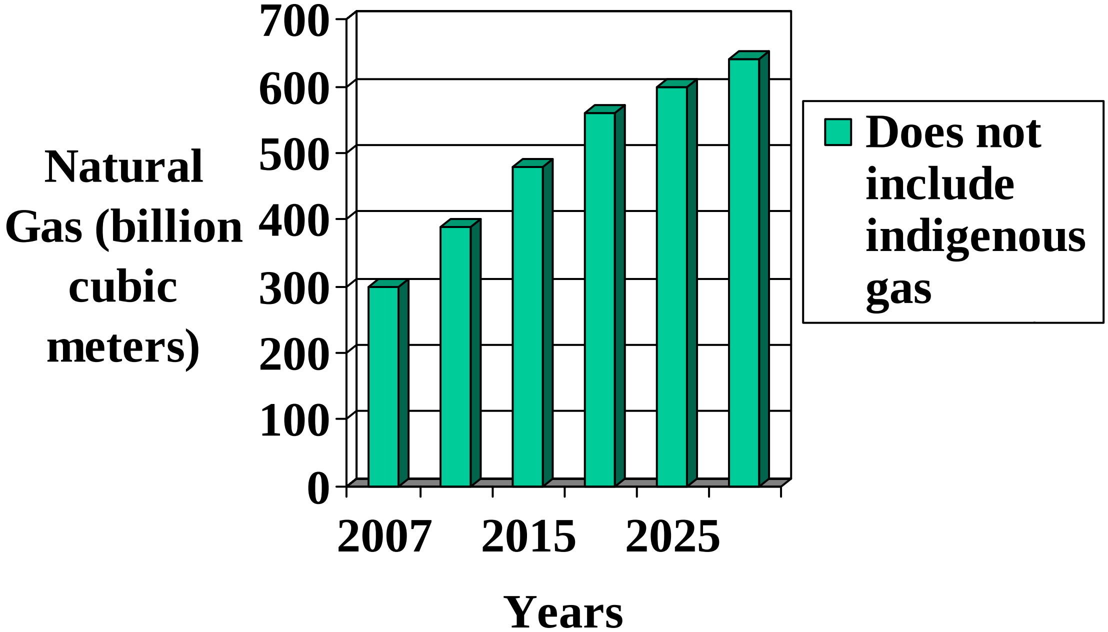
The West, led by cooperation between the EU and the U.S., needs to quickly rethink its energy and non-energy policies with Russia. The two cannot be separated. The world does Russia no favor by ignoring the monopoly and noncompetitive nature of this energy relationship. All sides would benefit if Russia were to become more transparent and commercial in its foreign energy policies. Meanwhile, neither EU nor U.S. should allow Moscow to threaten the security of Europe, particularly the new democracies of Central Europe through neglect or unwillingness to face down the new imperial mindset in the Kremlin. As Yuri Schmidt, the famous Russian human rights lawyer told audiences in Brussels in October, "Yes, Russia needs something from you. It needs your silence, and it is ready to pay you for it, too." The January 1 wake-up call to the West was also an opportunity for those who want to see Russia build a modern, democratic state that is linked to Europe by mutually beneficial political and economic ties.

Appendix

Projected U.S. Net Gas Imports 2004-2030



Projected Natural Gas Imports EU-30 2007-2030



BIOGRAPHY OF AMBASSADOR KEITH C. SMITH

Ambassador Smith is at present a Senior Associate in the Europe Program at the Center for Strategic and International Affairs (CSIS). Previous to that, he was Advisor in the Russia and Eurasia Program of CSIS. From 2000 to 2002, he was a consultant on international energy affairs. CSIS has published two monographs of Ambassador Smith; one on Russian-Baltic Relations, in 2002 and another in December 2004 entitled Russian Energy Politics in the Baltic States, Poland and Ukraine.

In 2000, Ambassador Smith retired from the State Department's Foreign Service after serving from 1997 to 2000 as the American Ambassador. This followed a long career in the Foreign Service, which focused primarily on Europe. Most recently, he was posted to Hungary (twice), Norway, Estonia and finally Lithuania. At the State Department, his most recent assignments were as Director of Policy for Europe, Senior Deputy for Support for East European Democracy and Director for Areas Studies at the Foreign Service Institute.